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MEMORANDUM FOR: THE RECORD

The attached was requested and forwarded to NIO/USSR as a background paper for DCI briefings.

Office of Economic Research

Date 6 June 1979

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THE SOVIET ECONOMY AND THE SUMMIT
(Short Version)

Joint OER/OPA Paper
June 1979

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I. The Soviet Economy on the Eve of the Summit

The long-term outlook for the Soviet economy remains bleak, and the disappointing performance over the last six months has further driven home to the leadership the fact that rising resource costs, impending energy and labor shortages, and sluggish productivity cannot be overcome easily or soon. The winter of 1978/79 nearly brought economic growth to a standstill, raising demand for energy while at the same time making energy and other raw materials more difficult to produce and distribute

Outlook

On balance, the short-term outlook for the economy is gloomy. Poor industrial performance in 1979 will impede the investment programs that underlie Moscow's efforts to turn the economy around. Investment growth will be harder to achieve in 1979 because of shortfalls in construction materials, machinery, and ferrous metals. This, in turn, will hinder efforts to accelerate additions of new industrial capacity, setting back Moscow's program to modernize the economy's stock of plant and equipment

More important, longer-term prospects are worse. Our forecasts on energy production seem to be holding true. The USSR's oil industry is likely to enter a no-growth stage

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by 1980, followed by steady production declines in the early 1980s (Figure 1). West Siberia, which accounted for more than two-fifths of Soviet oil production in 1978, is the key to oil prospects for the foreseeable future because rising output in this region is currently offsetting progressively steep declines in the remainder of the USSR. West Siberia, however, faces serious difficulties and a probable decline in output in the early 1980s. Especially significant is the anticipated drop in oil production at the super-giant Samotlor oilfield by 1980-81. We believe that even a moderate decline in West Siberian production would lead to a sharp drop in national production.

Soviet officials also acknowledge the challenge to policy implicit in the adverse demographic trends expected in the 1980s. The natural increase in the working-age population will drop off to about 300,000 per year by the mid-1980s (Figure 2). Moreover, from now until the late 1980s, increments to the labor force will come almost exclusively from the less-skilled and less-mobile Turkic populations of Central Asia and the Transcaucasus republics. But most of the growth in energy and raw material supplies, especially energy, is occurring east of the Urals, while most industrial capacity is still in the European areas of the USSR.

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The critical policy issue will be the competition for investment/^{resources} among (1) Central Asia, where most of the growth in labor will occur, (2) Siberia, where the infrastructure and industrial facilities needed to exploit energy and other raw materials are sorely lacking, and (3) the European USSR, which is labor short and raw materials and energy poor but where investment can be carried out more cheaply by modernizing and expanding existing facilities rather than by building plants from the ground up. In any case, Central Asian and Siberian development will preempt an increasing share of total investment, while the growth of total investment continues to decline.

The impact of impending resource constraints on the USSR's economic growth cannot be softened if the Soviets are no more successful than in the past in using labor, capital, and natural resources more efficiently. Although the leadership recognizes the need for change, the Soviet system is not designed to change easily. The foundations of the system -- directive planning, central allocation of resources, administratively-set prices, and incentives oriented toward quantitative production goals -- discourage innovation and encourage redundancy and waste in the use of resources. Thus, productivity gains from additional labor and capital are low and have slumped in the 1970s. Rising costs of extracting, processing, and delivering raw materials, together with slower growth of fixed capital make a rebound in productivity unlikely under the present system.

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Meanwhile agriculture remains a major economic headache for the Soviet leadership. Although Soviet farm production has climbed well above the level of a decade ago, severe shortages of meat and quality food persist. Some of the rise in farm output reflects a massive infusion of investment, but relatively good weather has been responsible for roughly half of the increase in grain production between the early 1960s and the mid 1970s. This situation could change in the 1980s if weather conditions become more normal -- that is, harsher. While the outlook for agricultural production is uncertain at best, consumer incomes and expectations will continue to rise and with them the demand for more and better quality food. Soviet leaders will probably have to continue buying large quantities of grain and other agricultural products

On balance we expect growth in GNP to continue to slow -- averaging about 3 percent per year for the next few years and then dropping to little more than 2 percent in the mid-1980s because of increasing energy and manpower constraints.

Economic Policy Choices

Faced with these prospects, President Brezhnev and his colleagues must come to grips with hard choices over resource allocation in the very near future. Fundamental policy decisions must be taken over the next year as the economic plan for 1981-85 is being formulated and as measures looking forward to 1990 are approved. These decisions are further complicated by the necessity to consider the future needs and potential of the East European client states, whose dependence on the USSR for energy and other raw materials is likely to increase in the 1980s.

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So far there is no evidence that the Soviet leadership has settled on a long-term strategy for coping with its economic dilemmas. Instead, it has been temporizing on policy decisions; reacting rather than redressing. Arguments over allocation decisions and management of the economy reveal conflicting claims and divided advice at the middle levels of government, and caution verging on immobility in the Politburo.

II. Impact of Economic Problems on Arms Limitation and Soviet Defense Spending

The Soviet Attitude Toward Defense Spending

President Brezhnev and Premier Kosygin have frequently alluded to the weight of the arms burden on the economy, and the Soviets obviously recognize that high levels of defense spending impose serious economic costs -- notably in investment, but also in consumption. Although Brezhnev is likely to deplore these costs at the summit, the perceived benefits derived from military spending have made Soviet leaders less resentful than we are of high defense budgets, and more willing so far to make the economic tradeoff. They accept the economic sacrifice because they believe it does in fact enhance Soviet military security. They also accept it because the achievement of substantial military gains vis-a-vis the US provides a foundation for demanding acceptance of all the other claims of superpower status, and for projecting Soviet influence across the globe. They

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realize that the Soviet Union's role as a great power has its origin far more in military might than in economic efficiency or in the attractiveness of the Soviet political model. Nonetheless, the deteriorating economic situation could well lead the Politburo to strike a new balance between the economic costs and political benefits of continuing growth in military spending.

Momentum of the Soviet Arms Buildup

If the Soviets follow through fully on programs now in train, overall defense outlays -- which presently constitute 11-12 percent of GNP -- would continue to rise at a rate of 4-5 percent annually through the early 1980s -- even if SALT II enters into force. As a result, growth in defense spending would far exceed growth in GNP (Figure 3). Qualitative factors alone will tend to push Soviet defense spending up in the 1980s, especially the requirement for high technology solutions to current force deficiencies and future US threats. High technology weapons systems projected for the 1980s will be particularly costly. Advanced aerodynamic weapons, high technology electronics -- especially sophisticated radars, submarine detection and communications systems -- and advanced nuclear weapons designs will account for a large share of procurement expenditures. These expenditures -- together with continued rapid growth in RDT&E -- will shape the trend of total defense expenditures.

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Decisions regarding military programs now in train were reached some time ago and probably could be altered only at the margin -- perhaps by stretching out and some selective pruning if mounting economic pressures forced action on this front. However, decisions made from now on, which will affect resource allocations for defense in the mid-to-late eighties, may show greater concern for the military drain on the economy.

From the economic standpoint, the importance of SALT II to the Soviets therefore lies not in immediate savings, which are small in relation to the total level of military spending, but in future cost avoidance that SALT II makes politically conceivable. Ratification of the SALT II Treaty by the Senate would make it easier for Soviet leaders inclined to do so to argue that the danger from the West has slackened and that more resources can be directed to meet civilian economic needs. Such an argument would also come into play in justifying further arms limitation initiatives -- for example SALT II or MBFR.

SALT II and followup arms talks would also provide - political basis for advocating -- and obtaining -- an expansion of trade ties with the West. Given the present state of the economy, Soviet leaders may see their economic and military aspirations best served by a policy of increasing commercial relations with the West and encouraging an influx of Western

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machinery and technology. Advanced Western equipment and technology imported by the USSR often has both civilian and military-related applications, so a greater flow of such technology inevitably helps military-related production. The flow of technology already touches sensitive areas in the computer and electronics fields. Warmer relations, especially with the US, would also encourage the West to grant more credits on better terms to the USSR in the 1980s, when we expect an economic crunch. For a time such credits would support a welcome inflow of resources, which -- however -- would have to be repaid by an excess of Soviet exports over imports -- probably in the 1990s.

III. Impact of Economic Problems on Trade with the West

In the mid-1970s, the Soviet leadership -- confronted with rising hard-currency debt, difficulties in assimilating Western technology, and perhaps some domestic opposition to squandering the national patrimony -- seems to have taken a more cautious attitude toward commercial relations with the West. They have learned that even under detente Western governments cannot commit their private sectors to increased trade with the USSR. In addition, the cyclical behavior of Western markets has made export planning difficult, and Soviet manufactured goods have made little headway in these markets. The conservative stance toward trade taken during 1977-78 probably will yield in the 1980s, however, to a policy of exploiting East-West trade for all possible help in surmounting domestic economic problems. []

[] [] in April 1979, the Plenum decided that because of the "bad" state of the Soviet economy, more attention must be paid to the economy in the future, and Soviet foreign policy must be used in support of internal economic development.

Importance of Trade and Credits in the 1980s

The USSR should have little difficulty borrowing in the West if it chooses to do so over the next few years. Bankers and governments consider the Soviet Union to be a good credit risk, and bank liquidity is high. As domestic oil production tails off, however, oil exports for hard currency are likely to fall as Moscow balances the requirements of Eastern Europe against the growing needs of the Soviet economy. We believe that the USSR will have to import Western oil on a net basis by the mid-1980s, a shift that will encroach on Moscow's capacity to buy grain and import Western machinery and technology.

Thus, the expected economic slowdown, and the energy situation make commercial and scientific relations with the West all the more valuable to the USSR. First of all, the USSR will need imports from the West to deal with particular domestic shortfalls:

- The leadership's policy of improving the consumer diet is expected to require between 15 million and 25 million tons of imported grain annually for the next several years.

- We do not expect the Soviets to overcome rapidly the difficulties in steel production that have led to large purchases of Western steel products in recent years. In particular, planned Soviet natural gas and oil pipeline construction will require substantial imports of Western large diameter pipe.
- During the 1980s, the USSR probably will have to spend hard currency to import oil -- mainly for Eastern Europe.

Because of the prospective decline in Soviet oil production, the impetus to obtain assistance in energy exploration and development will be especially strong. Meanwhile the importance of boosting productivity throughout the economy, probably will lead Moscow to seek additional Western technology and equipment for a broad range of sectors. But, Soviet imports will be held down by the competition with oil and grain for available hard currency. Under these circumstances, maintenance and expansion of Soviet trade with the developed West will depend increasingly on (1) its success in negotiating compensation agreements with Western firms so as to assure an expansion of exports and (2) its willingness and ability to increase markedly Soviet medium- and long-term debt to the West.

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Role of the US

Although the USSR can find most of the equipment, technology and credits that it needs in Western Europe and Japan, Soviet policymakers still have a high regard for US technology and believe that the US market has the potential to absorb substantial amounts of Soviet exports. Moscow seeks, above all, to obtain a sustained and secure trading relationship with the US, complemented by unhampered access to long-term government-backed credits.

The USSR views US participation in Soviet projects as highly desirable for several reasons. US firms are often uniquely suited to provide the technology, equipment and services needed for the large projects envisioned by the USSR. This is particularly true in the field of energy exploration and development. Only the US at the moment has a completely integrated petroleum industry that can provide the necessary engineering know-how, experience, equipment, services, and -- perhaps most important-- the capital to put together a complete technology package on a scale which can benefit the Soviet petroleum industry. Given current Soviet economic and energy problems, Moscow may well view this as an opportune time for a broad technical assistance program between the US and the USSR in which US firms would become more actively involved in Soviet oil exploration and production and other large-scale energy development projects. US firms for their part, are likely to become increasingly interested in such participation as the world oil supplies tighten.

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VI. The Economy and the Summit

What the Soviets Want

General Objective. The leadership in approaching the summit would undoubtedly like to encourage a dialogue with the US government that would lead over time to a predictable, sustained, and growing economic relationship. It would like to be able to count on the participation of the US private sector as it formulates its economic plans for 1981-85 and beyond; it believes such participation could make a difference in how the USSR copes with its economic problems in the 1980s.

Repeal of Jackson-Vanik and Granting of Most-Favored-Nation Status. In economic terms, the most immediate hoped-for gain from a repeal (or dependable waiver) of Jackson-Vanik would be access to government-backed credits. Passage of the Stevenson Amendment to Exim-bank legislation limiting credits to the USSR to \$75 million a year and \$300 million over four years (without Congressional approval) was probably more important than the Jackson-Vanik Amendment in leading the Soviets in January 1975 to disavow the trade agreement reached with the Nixon Administration. Moscow could hope for large-scale credits only if Stevenson Amendment restrictions are eased substantially.

Although the Soviets realize MFN is unlikely to lead to any short-term direct economic gain, Moscow undoubtedly

hopes it would improve the long-term prospects for manufactured goods exports to the United States. Indirectly, the receipt of MFN would be of value to the extent that it signifies an improved economic climate and encourages US firms to enter into negotiations with the USSR.

Credits. At a minimum, the USSR would like assurances that it can count on substantial US government-backed financing over the next five years. Currently, Western credit lines which have been made available to the USSR are underutilized; the availability of US credits would thus not necessarily lead to a rise in overall Soviet purchases under credits but would enable the USSR to divert some of its purchases to the United States.

A Trade Agreement. According to the Trade Act of 1974, a trade agreement must be signed before MFN may be extended to any given country. The Soviets would consequently almost certainly like to conclude an updated version of the 1972 trade pact, which would -- at a minimum -- address the MFN and credit issues.

A Long-term Cooperation Agreement. The Soviets would probably like to set the groundwork for a more comprehensive US government involvement in trade issues. Aside from obtaining credits and MFN, Moscow would probably like to conclude an overall cooperation agreement similar to the trade and cooperation pacts it has signed elsewhere in the West.

Renewed Grain Agreement. If grain issues are not resolved in the bilateral talks on this subject scheduled at the end of May in Moscow, the topic might arise at the summit. The Soviets possibly might ask the US to raise the purchase limits stipulated by the grain agreement above the 8-million ton ceiling in the next Long Term Agreement Year.

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Technology Transfer. The Soviets clearly desire the elimination of present controls on the export of petroleum technology and equipment. President Brezhnev might stress the importance for detente of continuation of the bilateral exchanges on science and technology. The major issue outstanding at the moment is renewal of the energy agreement, which comes up for resolution at a Joint Commission meeting in June. The US has proposed a three-year renewal, while the Soviets want a full five-year term. The access to US work in the energy field provided by the agreement is highly valued by Soviet scientific leaders and energy administrators.

Restraints in Military Spending. Along with apprehension over US advances in military technology and a desire to restrain NATO modernization, economic constraints _____

_____ may induce President Brezhnev to offer new proposals for expediting ongoing arms negotiations or speeding up SALT III. On the other hand, if Brezhnev tables only a variant of earlier Soviet proposals for a mutual reduction of military budgets, this should not be seen as a reflection of Soviet economic difficulties or as a serious arms control measure. Previous proposals of this sort have not provided for verification, and the Soviets are aware of US objections to them.

What the Soviets Will Pay

At the present juncture, economic difficulties will not force the Soviet leaders to make significant concessions

to the United States in areas considered by them to be central to the USSR's economic, political, and military security interests, or to its global great power aspirations. The debate on the Soviet side is likely to be over concessions at the margin, largely economic but partly political and military. Here it is probable that the leadership is divided on how far to go. According to a recent account by [] [] [] the subject of expanded trade with the US had been discussed "seven times" by the Politburo, with members split over the issue of assisting the US Administration in resolving the problems posed by the Jackson-Vanik Amendment. [] [] [] was ordered by the Politburo to attend the recent US-USSR Dartmouth Conference in order to inform the leadership of any new developments in the trade field.

Perceptions of Leverage. The Soviets probably feel that they have a substantial capacity to resist US leverage in the economic sphere, and that this capacity will permit them to minimize any non-economic concessions we might demand at Vienna in return for greater access to US technology, goods, and credits. They think, with justification, that their import needs -- with the exception of grain and to some extent petroleum equipment -- can if necessary be largely satisfied outside the United States.

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The Soviets also see certain political forces within the US working in their favor. They are fully aware of the obstacles that constrain US manipulation of grain exports for political ends. They think, not without reason, that they can count on considerable pressure from US business circles for a relaxation of trade constraint. And in Washington they observe that Congress and the Administration now appear actively interested in resolving the issues of MFN and credits.

"Good Behavior" in the Third World. On the basis of experience to date, the Soviets have no good reason to believe that what they do in Africa, the Middle East, or elsewhere in the Third World significantly affects their economic relations with Western industrialized nations other than the US, and they must seriously doubt whether it even has any lasting impact on economic ties with the US. The Soviets count upon the need of Western countries for their business, and competition among these countries, to counter any tendency toward collective Western attempts to use trade to inhibit an aggressive Soviet foreign policy in Third World countries. What inhibitions there may be in promoting Soviet objectives in these regions arise more from political and military than economic considerations.

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Civil Rights. From President Brezhnev's standpoint the recent emigration decision represents a real concession to American pressure, and it is doubtful whether he will be willing to go much further down this path. It is highly unlikely that President Brezhnev would or could provide any assurance -- written or verbal -- that could be seen to link Soviet emigration policy and trade. []

[] have recently indicated, however, that President Brezhnev would be receptive to an approach that treated emigration and trade as quite separate agenda items. They seem to suggest that President Carter could raise the emigration issue in the context of a question about Soviet views on implementation of the Helsinki accords, which would give President Brezhnev an opening to observe that Soviet emigration policy was in line with Helsinki, that large numbers of people were currently emigrating, and that this level of emigration would be maintained in the future provided that there were sufficient applicants to maintain the flow. This statement would provide the assurance President Carter needed, without a politically unacceptable explicit obligation on the Soviet side. Following such an exchange, the trade issue could be treated completely on its own, with no reference to emigration.

The Soviets probably will not denounce a Presidential finding that they are in compliance with Jackson-Vanik, if this

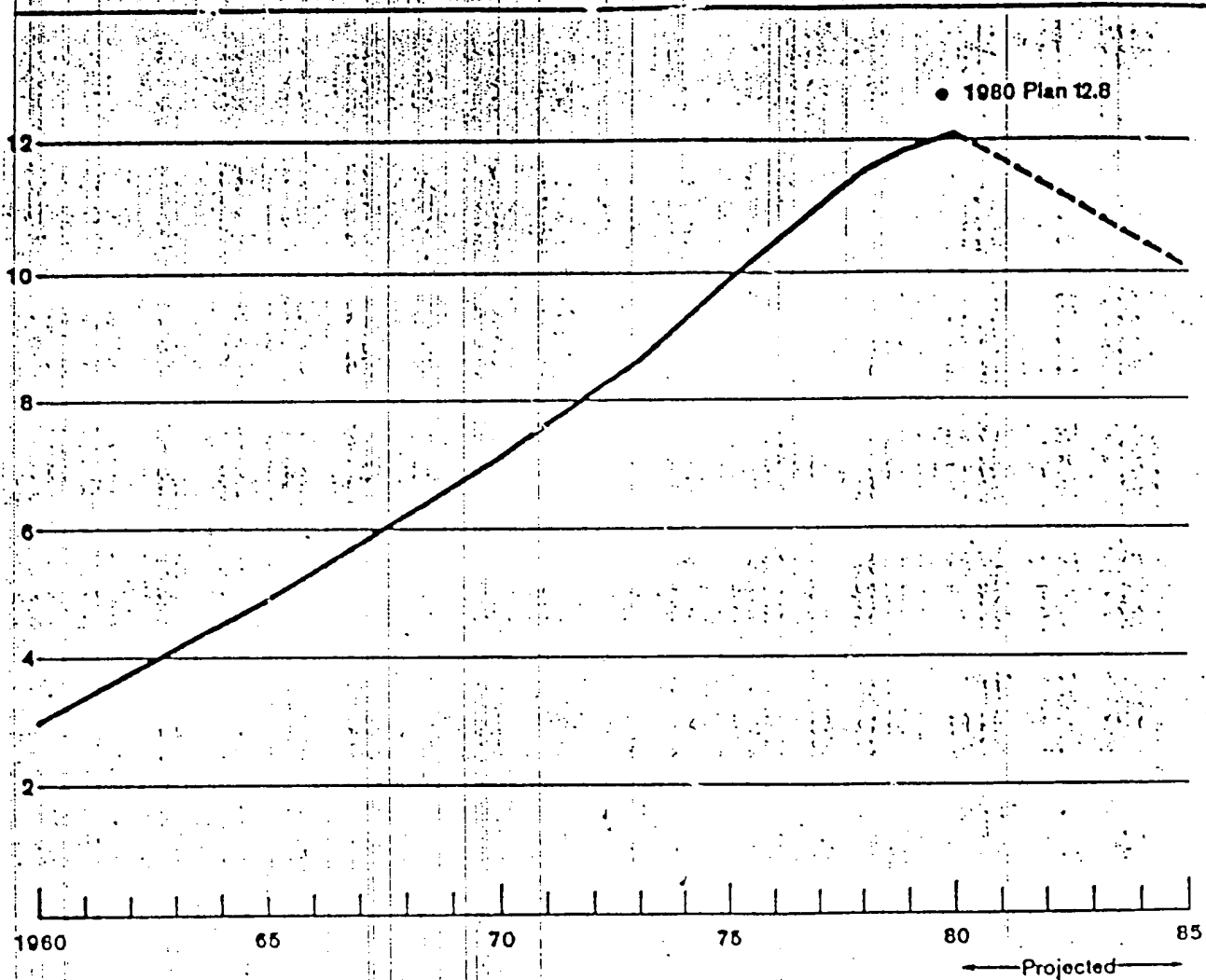
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finding and Congressional action on it are presented in temperate terms and as discretely as possible -- perhaps in tandem with authorization of MFN for China. If a waiver or repeal of Jackson-Vanik is not forthcoming or is not followed by guaranteed large and continuing credits, then the incentive to permit continued large-scale emigration would be reduced. A grant of MFN to China but not the USSR would reinforce the Soviet's worst suspicions of us and -- at a minimum -- evoke a forceful denunciation and demonstrative cutbacks of contracts wherever possible.

Economic Concessions. President Brezhnev will almost certainly dwell upon the bright prospects for compensation deals, and is unlikely to raise the question of forms of US participation inside the USSR that involve equity, production sharing, or even quality control. However, what he would say if pressed on these issues is uncertain. Lenin himself encouraged concessionary deals when the young Soviet economy was in serious trouble, and there were many of them in the 1920s. Poland and Hungary (not to mention Romania and Yugoslavia) today permit equity participation in their economies by Western firms, such as Volvo in Hungary -- presumably with Soviet acquiescence. More flexibility in this matter could be very beneficial to the Soviets, especially in offshore oil exploration and development and in the energy field in general. There is strong evidence that some Soviet officials would approve a softer line here, although the issue is controversial.

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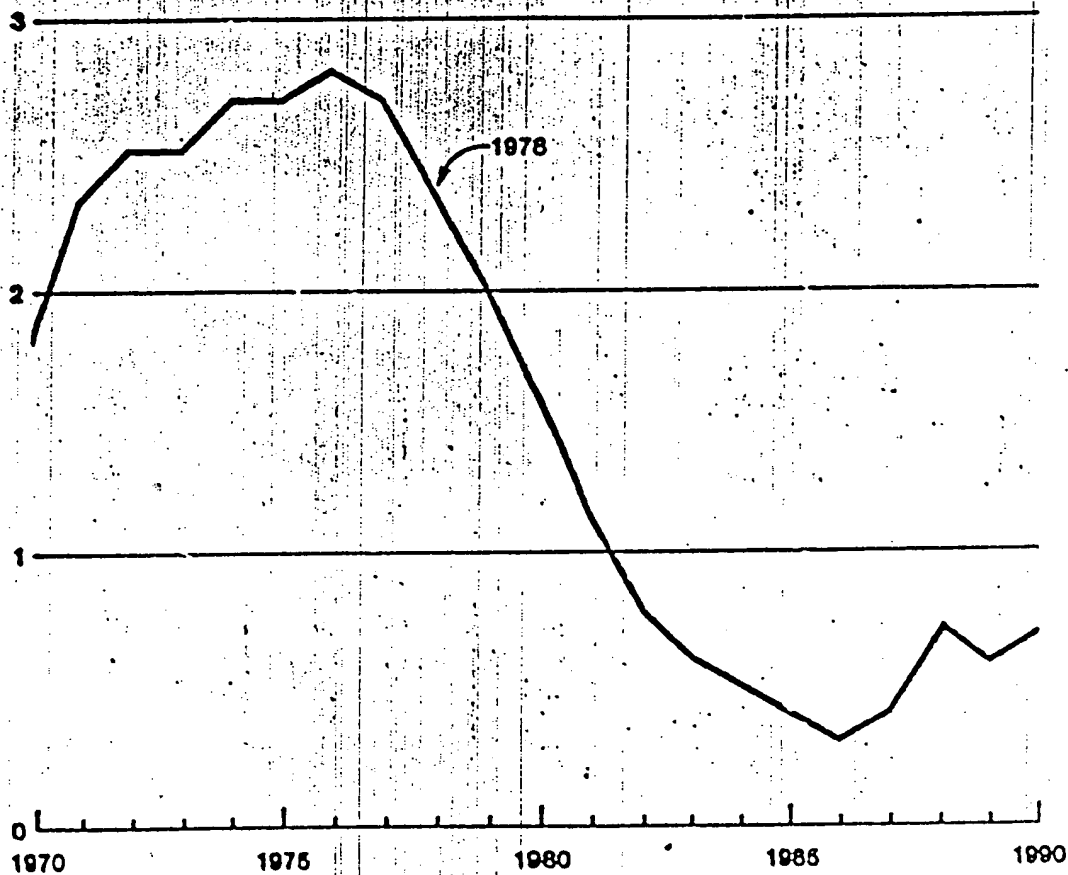
USSR: Crude Oil Production¹



¹Including a small amount of natural gas liquids (20,000 b/d in 1960 to some 300,000 b/d in the 1980s).

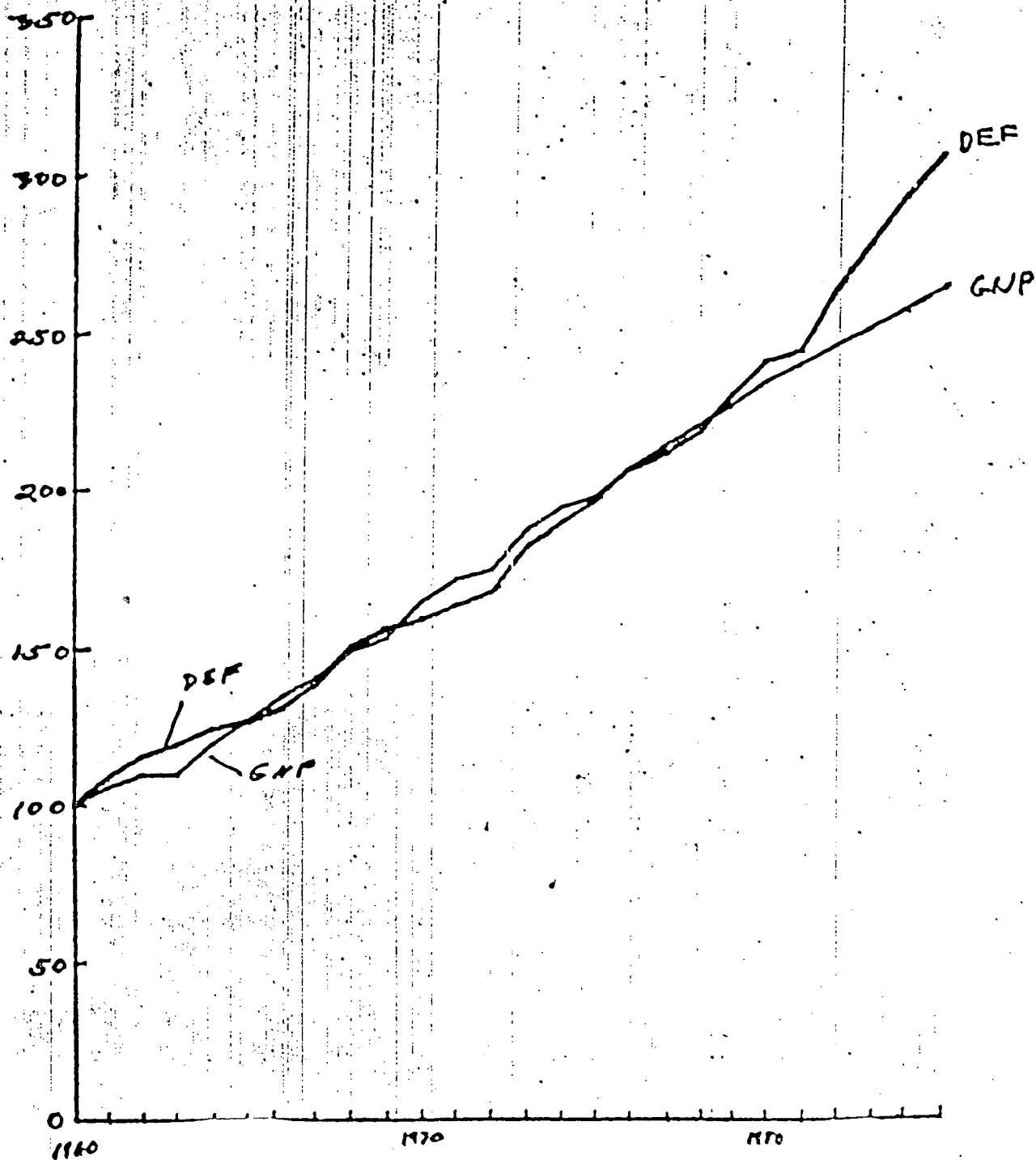
USSR: Growth of Working Age Population

(Annual increment in million persons)



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USSR: Increase in GNP and
Defense Spending, 1960-1985
(1960 = 100)



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